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C O N F I D E N T I A L SECTION 01 OF 03 DUBLIN 000086

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STATE FOR TREASURY VIMAL ATUKORALA

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TAGS: [PGOV](#) [PREL](#) [ECON](#) [EFIN](#) [EI](#)
SUBJECT: IRISH BANKING WOES: POLITICAL QUICKSAND

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Classified By: Acting Pol/Econ Section Chief Dwight Nystrom; reasons 1.
4(b/d)

11. (C) Summary: Recently, the Finance Minister Brian Lenihan announced a recapitalization plan for Ireland's two largest banks. The terms of the recapitalization stated that the government would receive preferred shares in exchange for the investment and the Minister for Finance would name 25 percent of both banks' boards of directors. The compensation of bank executives will be reduced by at least 33 percent. These banks are viewed to be the strongest in Ireland and economists and ex-management of other banks indicate that Ireland's smaller banks will likely require government support. Further, troubles continue to unfold at Anglo-Irish bank, with the revelation of an additional Euro 451 million in bad debt associated with the bank financing the purchase of its own shares. The Irish police executed a search warrant on Anglo-Irish's offices in connection with the growing scandal. According to several of our contacts, the banking sector troubles are becoming a political problem for the government. As well, the small, generalist Department of Finance is finding it difficult to deal with the twin crises of the banking meltdown and an expanding fiscal deficit. End Summary.

OWNERSHIP

12. (U) Under the terms of the recapitalization plan, the Government will provide Euro 3.5 billion in Core Tier 1 capital to Allied Irish Bank (AIB) and Bank of Ireland (BOI). In return, the government will receive preference shares with a fixed dividend of 8 percent payable in cash or ordinary shares in lieu of cash. Until the fifth anniversary of the issue, the banks have the ability to repurchase the preference shares at par value. After that time, they may be repurchased at 125 percent of face value. Warrants attached to the preference shares enable the government to purchase up to 25 percent of the existing shares if share prices reach a specific level. The strike price for the first 15 percent is Euro 0.976 for AIB and Euro 0.52 for BOI. The strike price for the balance is Euro 0.375 for AIB and Euro 0.20 for BOI. As of market close on February 23, the share prices for AIB and BOI were Euro 0.58 and Euro 0.30, respectively. If a bank redeems up to Euro 1.5 billion of the state investment in new preference shares from privately sourced Core Tier 1 capital prior to December 31, then the warrants will be reduced pro rata to that redemption to an amount representing not less than 15 percent of its ordinary shares.

MANAGEMENT AND FUNDING SOURCES

13. (C) The Minister for Finance will name 25 percent of the

directors at each of the banks. Additionally, the government will receive 25 percent of the voting rights in respect of change of control and board appointments. All directors of both banks will resign prior to the 2009 annual general meetings. Additionally, compensation of senior executives will be cut by at least 33 percent. They will receive no bonuses or salary increases related to performance in 2008 or 2009. Payments to non-executive directors will be reduced by at least 25 percent. The recapitalization program will be funded from the National Pensions Reserve Fund, with Euro 4 billion from the fund's current reserves and Euro 3 billion from a front loading of the Exchequer contributions for 2009 and 2010. Alan Barrett of the Economic and Social Research Institute (ESRI) indicated that the expenditure and related indebtedness is relatively minor given Ireland's debt to GDP at the beginning of 2009.

CONTINUED DIFFICULTIES AT ANGLO-IRISH

14. (U) On February 20, Anglo-Irish Bank revealed that it lent 10 customers (nicknamed "the golden circle" in Ireland) Euro 451 million to purchase Anglo-Irish shares, with 75 percent of the loans secured by the shares and 25 percent secured by the participants' "personal assets." David Drumm, Anglo-Irish's former chief executive, assembled the group to purchase 10 percent of the bank's shares in order to prevent shares acquired through contracts for difference with businessman Sean Quinn coming to market. He feared that this would have led to a sharp decline in share price. On February 22, the Irish Times reported the names of four of the investors, all of whom are well-known real estate developers. Anglo-Irish expects to write off Euro 300 million in relation to this transaction.

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15. (U) On February 24, the Garda (the Irish police force) executed a search warrant on a number of Anglo-Irish Bank offices in Dublin. According to press reports, the police are searching for documents that could provide evidence of offenses under company law. Justice Minister Dermot Ahern said, "legislation is in place to bring to justice those who may have played hard and fast with the financial security of this country." He continued, "we operate the rule of law. As far as I am concerned, that provides that, whether you have a balaclava, a sawed-off shotgun or a white collar and designer suit, the same rules apply."

THE FUTURE OF BANKING IN IRELAND

16. (C) Economists generally agree that AIB and BOI are on sound footing. However, they have expressed considerably more concern over the smaller banks. Barrett indicated that the Irish people would have been better served had Anglo-Irish been allowed to fail. Rumors continue to surround the future of Irish Nationwide, whose former Chairman, Dr. Michael Walsh, resigned on February 17. The building society is currently run by 71 year old former managing director, Michael Fingleton. Following his surprise resignation, Walsh stated that Irish Nationwide could not survive without significant government support. The Department of Finance is currently reviewing the likely capital needs of Irish Nationwide, Irish Life & Permanent, and EBS building society. Barrett indicated that there would likely be continuing fallout in the sector.

17. (C) Embodys have had recent conversations with others who agree with Barrett that there is more to come from the banking scandals. Andrew McDowell, economic advisor to opposition party Fine Gael, said that Fine Gael hopes that the Euro 7 billion bank recapitalization scheme works but that it is probably only a temporary solution. Unfortunately, he said that was all the money the government could pull together at the time. He worried that in three

months the government will need to inject fresh capital into the banks and he was unsure where this money would come from.

Fine Gael preferred the idea of setting up a "bad bank" that would hold the bank,s impaired assets. McDowell also believes that we have not seen the end of revelations of misconduct in the banking sector. However, he said for the time being opposition parties are not going to cause a fuss over the issue because of the fragility of the economy but in a few months "all bets are off."

18. (C) Eoin Fahy, chief economist at KBC Asset Management, worried that the scandals at Ireland's banks are permanently damaging the country's image as a safe, steady place for financial institutions to do business. He said that the "light touch" regulatory system that has served to draw in these firms will be revamped with the result that firms will leave. Fahy confirmed that the low corporate tax rate is "untouchable" but he worried if this was enough to keep these companies in Ireland (Note: Fahy is on the Commission on Taxation, which was tasked by the government to make recommendations about how to improve the tax code. End Note.) Fahy noted that it is "quite likely" that the Fine Gael leadership knows the identity of "the golden circle" individuals but he is not convinced that the Fianna Fail leadership does. He asked two Cabinet-level Fianna Fail members (who happen to be personal friends) whether they knew the identities. They maintained they did not. Nevertheless, he believes, "this will not end well for the government."

COMMENT

19. (C) Economists generally believe that the banking sector will weather the current storm and that AIB and BOI will emerge from the wreckage. However, the fate of the smaller banks is more uncertain. Our contacts agreed that the banking crisis is rapidly becoming a political headache for the government and that the government's raid on Anglo-Irish's offices may be an indication of the desire to deal firmly with the problem. The public has come to believe that the revelations about Anglo-Irish to date represent only the tip of the iceberg. Beyond the scandals, the government's lack of institutional capacity to deal with the banking crisis and a burgeoning fiscal deficit at the same time is worrying. According to Barrett, the generalist nature of the civil service diminished the ability to adequately monitor and regulate financial institutions and allowed larger organizations to dictate to the regulators, who were wholly incapable of understanding the deception present in Anglo-Irish. Unless the government acts quickly

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to rectify this problem, Ireland's tarnished reputation could blacken further.

FAUCHER